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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC., et al,
Petitioner,

VS.

MICHAEL BROUDO, et al.,
Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

BRIEF FOR JAMES J. HAYES AS AMICUS CURIAE SUPPORTING RESPONDENTS

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INTEREST OF AMICUS CURIAE

James J. Hayes[1] is an active individual investor with more than 40 years experience buying and selling millions of dollars U.S. equities ranging from speculative IPO's like Radview Software to blue chips like Kimberly Clark. He is a long term owner of Dura purchasing 1,000 shares on 9/26/98

[1] Pursuant to Rule 37.6, James J. Hayes states that no counsel for a party authored this brief in whole or in part and that no person made a monetary contribution to its preparation. The Petitioners' consent to the submission of this brief is submitted with this brief. Respondents have previously filed a blanket consent with the Clerk.

about a month before Dura's Spirios Albuterol new drug application (NDA) was denied by the FDA. He is not a class member, however, and has no direct financial interest in the outcome of this case.

Mr. Hayes is a long time student of equity markets completing, for example, Dr. Frederick Amling's graduate courses in securities and portfolio analysis and Dr. John Kendrick's graduate course in business cycle analysis at the George Washington University.

As an investor, Mr. Hayes is interested in a legal system that protects rights of minority shareholders and fairly compensates shareholders victimized in market based securities fraud. This is particularly germane now with the unprecedented increase in major fraud cases before the courts. A more responsive legal system would improve the efficiency of our equity markets and increase national wealth.

In 1990 Mr. Hayes filed an amicus brief with this Court in Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991); arguing that shareholders were unconstitutionally denied appraisal rights in that takeover. The failure of the courts to provide a remedy for minority shareholders from unfair takeovers affected by majority vote could reduce market efficiency by discouraging investor participation in the markets and causing remaining investors to reduce prices they are willing to pay for individual stocks. Market efficiency improves when investors can confidently bid what they believe a stock is worth without discounting for the probability of exploitation by the majority in a merger or for relying on false corporate disclosures.

In current cases relevant here, Mr. Hayes is a named plaintiff in a proxy fraud (14-a) case against Crown Central Petroleum, its officers and directors, in a takeover by its

largest shareholder. As a class member, he is also protesting the settlement of a classic fraud-on-the-market 10b-5 case against Nice Systems Inc. This Court recently denied a writ of certiorari that case, James J. Hayes vs. Nice Systems Ltd., et al., No. 03-1676. Mr. Hayes anticipates filing a Rehearing Petition on November 29, 2004 after Justice Souter granted petitioner's application to extend time for filing a rehearing petition.

INTRODUCTION

A. Tightening Pleading Requirements For Loss Causation Is The Wrong Solution For the Wrong Problem

The premise underlying the arguments of several amici is that the country is being inundated by wave of meritless securities class action law suits that force defendants to pay nuisance settlements because of the huge amount of potential damages. They lament that despite the 1995 passage of the Private Securities Litigation Reform Act (PSLRA) that American business continue to contend with "*lawyer-driven machinations the PSLRA was designed to prevent.*" (U.S. Chamber of Commerce (Chamber) Br.10, citing In re BankAmerica Corp. Sec. Litg., 95 F. Supp. 2d 1044, 1050 (E.D. Mo. 2000))

The amici' solution to a problem – that amicus Merrill Lynch (ML) characterizes as "blackmail settlements" with "windfall recoveries" – is a single "*rigorous loss causation standard.*" Their strict standard would only apply to fraud that is publicly disclosed by a timely statement that corrects the misleading statements that have previously inflated the corporation's stock price. Absent a correcting disclosure, the suit would be dismissed. The problem, however, is that corporations fraudulently inflating their stock price rarely make a corrective disclosure. Rather corporations are careful

to obscure the fact that their prior statements were false or misleading.

1. Amici' Solution Ignores Recent Wave Of Corporate Fraud

The amici fail to acknowledge that beginning in the late 1990's this country experienced a unprecedented increase in accounting and financial fraud that included the largest U.S. companies including Enron, Worldcom, and Tyco and in some cases the auditors and investment bankers. Enron's auditor, for example, was successfully prosecuted by a special task force in the U.S. Department of Justice for criminal fraud. In response, Congress passed Sarbanes/Oxley to tighten accounting standards and then require the CEO and CFO certify their company's financial statements.

Amici failure to acknowledge the recent wave of security frauds that have shocked millions of investors, raises questions on their credibility; their presumptions on the significance of meritless securities class actions proceeding to settlement and their arguments for tightening loss causation pleadings.

2. Accounting Fraud Is Distinguished From IPO Fraud

The accounting fraud problem is complicated by the internet and dotcom revolution that led a boom in technology stocks in the late 90's that produced an unprecedented increase in new public offerings (IPO's). Spectacular stock gains followed in initial trading which continued until the economy began to slow in 2000. ML characterized the rapid increase in stock prices of recently issued IPO's as a huge stock market "bubble" which simply burst causing trillions of dollars in market losses within a matter of months. However ML didn't explain that the unprecedented price increase in the new IPO's was aided by the allocation practices of major

underwriters. Investigations by the New York Attorney General and the SEC found that certain underwriters tied allocations in their IPO's to requirements to purchase additional stock after the stock began public trading in the market. Such schemes could artificially inflate prices paid by an unsuspecting public. The investigations also determined that certain underwriters' analysts buy recommendations to their brokerage clients did not represent the professional opinions of the analyst. ML Br. 20.

In December 2002, the nations leading underwriters settled these charges for $1.4 billion. ML – who duplicity represents its "*experience with post bubble suits*" as "*useful to the Court*" – paid $200 million in restitution and investor benefits. ML Br. 2 & 26. Typically, ML never issued a corrective disclosure about its analysts' false recommendations and under the loss causation standards it advocates here these suits would be dismissed for failing to plead loss causation.

ML is right that without a corrective disclosure determining investors' damages are complex and uncertain; however, it is clear there was a bubble and ML and other investment bankers were blowing it up. The scheme provided the underwriters enormous fees that were enhanced as the spectacular price gains attracted a growing number of underwriting clients. In the complex world of securities fraud, a general statement pleading loss causation should satisfy the pleading requirements of the PSLRA with the specific amounts of damages determined after discovery allows a full analysis of the complex factors causing the collapse in prices. If ML and other leading underwriters were blowing up a "speculative bubble" shouldn't they share some liability when the "bubble" bursts?

Extensive investigations by Congress, the New York Attorney General, the SEC, the Justice Department and

various U.S. attorneys have shown that the largest and most spectacular of the securities frauds discovered after 1998 were real. Documenting only a few of the frauds has taken an enormous amount of time and continues today, six years after the frauds were active. Indeed it was on November 4, 2004 that the first guilty verdicts were obtained in a single incident in the complex Enron fraud. Four ML investment bankers and an Enron executive were found guilty of fraud in connection with a scheme to inflate Enron's 1999 earnings.[2]

Amici briefs avoid the recent wave of complex securities fraud schemes in arguing that "*meritless securities actions threaten to slow the spread of new investments, reduce the efficiency of capital markets and limit competitiveness of the American economy.*" Chamber Br. 2. On the other hand pre-discovery dismissal of meritorious fraud cases and failure to compensate investors fairly for their fraud losses threatens to drive investors from the market with the same dire consequences identified by the Chamber. The sheer complexity of information effecting today's markets make it impossible to simply dismiss well pled fraud allegations on the presumption that some have little merit. The lengthy investigation of Enron shows that full discovery is required to avoid dismissing the meritorious cases.

3. Reducing Meritless Securities Litigation Requires Balancing PSLRA Dismissals With PSLRA Shareholder Empowerment

There is little evidence to show that more rigorous interpretation of PSLRA pleading requirements are a solution to the problem of meritless securities suits. A Federalist Society study found that the average dismissal rate following PSLRA

[2] Emshwiller & Scannell, *Enron Trial Results in Five Guilty Verdicts – Convictions of Merrill Bankers Show Advisors Can Be Liable For Helping Mislead Investors*. Wall St. J., Nov. 4, 2004 at C-1 E.

was 25.1% more than double the 11.2% dismissal rate prior to the PSLRA.[3] Indeed, Brian Lehman, a legal commentator, argues that a substantial number of meritorious cases are being dismissed because circuit courts are requiring investors to prove their case in the pleadings![4] Lehman cites the pre-discovery loss causation dismissal In re Merrill Lynch & Co., Inc. Research Reports Securities Litig., 273 F. Supp. 2d 351 (S.D.N.LY. 2003) noting that causation is typically considered a question for the jury. A fraud suit against WorldCom was dismissed just three months before the company's internal auditor alerted directors and the public about WorldCom's fraudulent overstatement of earnings that led to its bankruptcy. And finally the Enron fraud could not satisfy the loss causation standard advocated by the petitioner. (See B p17) In the aftermath of unprecedented level of real securities fraud, the important issue is whether significant numbers of meritorious suits are being dismissed prior to discovery.

Now, finally circuit courts have recognized that pre-discovery dismissals are requiring plaintiffs to prove their case in the pleadings. The Seventh Circuit in Asher v. Baxter Int'l Inc. 377 F. 3d 727 (7th Cir. 2004) (Baxter) determined that securities fraud suits cannot be dismissed under the safe harbor provisions of PSLRA prior to discovery.[5] Clearly,

[3] Painter et al., *Private Securities Litigation Reform Act: A Post-Enron Analysis,* The Federalist Society for Law and Public Policy Studies, (2003) at 7, http://www.fed-soc.org/pdf/PSLRAFINALII.PDF

[4] Lehman, *Misinterpretation of fraud statute led WorldCom case dismissal*, Findlaw, http: //www.com/2003/LAW/09/05/findlaw.analysis.lehman.worldcom/

[5] Asher v. Baxter Int'l Inc., 377 F. 3d 727 (7th Cir. 2004) focuses on the safe harbor provisions of PSLRA (15 U.S.C. 77z-2(78u-5(c)) whereby companies can insulate themselves from securities fraud litigation provided they include "*meaningful cautionary statements identifying*

amici arguments for a more rigorous loss causation standard is the wrong solution for the wrong problem at the wrong time.

Dismissing securities class actions prior to discovery pursuant to the enhanced pleading requirements in the PSLRA is only one of the provisions Congress intended to reduce meritless securities suits. According to the SEC, PSLRA made a number of changes to class action procedures to "*empower investors so that they, not their lawyers, control securities litigation*," SEC Br. 14 quoting S. Rep. No. 98, 6.

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important factors that could cause actual results to differ materially from those in the forward-looking statement." Baxter's forward looking statement included a projection that in 2002 revenue would grow in the "*low-teens*" and earnings-per-share would grow in the "*mid-teens*" compared with 2001. By the second quarter of 2002 however, Baxter announced that sales and profits did not match these projections and on that announcement Baxter shares fell from $43 to $32.

The district court determined that Baxter's projections included "*meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.*" and dismissed the complaint for failure to state a claim on which relief may be granted. Baxter at 730.

In overruling the district court, Judge Easterbrook reasoned that: "*any particular caution, which always may be challenged as not sufficiently 'meaningful' or not pinning down the 'important factors that could cause actual results to differ materially.*" Id. 729.

...

Baxter's chosen language may fall short. There is no reason to think... at the pleading stage, before plaintiffs have access to discovery – that the items mentioned in Baxter's cautionary language were those thought at the time to be the 'important' sources of variance. Id. 734.

...

"Thus this complaint could not be dismissed under the safe harbor, though we cannot exclude the possibility that if after discovery Baxter establishes that the cautions did reveal what were, ex ante, the major risks, the safe harbor may yet carry the day." Id. 735.

In particular, settlements of meritless suits provide little benefit to investors but handsome fees for their lawyers. Congress recognized the situation required better disclosure in the settlement notice to provide estimates of damages, attorney fees and plaintiff recovery on a per share basis so that investors and the courts could evaluate the fairness of the settlement. Armed with information, class members could challenge nuisance settlements including attorney fees which do not seem appropriate where class members receive a low recovery. Eliminating attorney fees in settlements that provide little benefit to shareholders would quickly shut off the oxygen fueling meritless suits.

Granting the Hayes petition for writ of certiorari in NICE Systems, Ltd., case number 03-1676 in conjunction with the Dura appeal would enable this Court to reach a balanced interpretation of the PSLRA that would discourage meritless securities class actions and permit shareholders to recover meaningful damages in the meritorious cases.

B. Proscribing Aggregate Damages in Settlements Would Discourage Filing Of Frivolous Securities Class Action Suits

Frivolous securities law suits are driven by the certainty of multimillion dollar fees awarded to class action lawyers for achieving token settlements that provide little or no benefit to class members. Chamber Br. 8 n.16. The Chamber tacitly acknowledges that this rather than lax pleading standards is the driving force behind meritless litigation. "*Securities class action suits, moreover, often benefit class counsel more than they do class members...*" Chamber Br. 2. Even in meritless suits, six and seven figure fees are the norm because the potential damages – even for small companies with actively traded securities – are tens or hundreds of times greater than the settlement. Class lawyers benefit because

they have devised a manipulative settlement evaluation scheme that allows the deduction of legal fees from the gross settlement rather than share the tiny awards to individual class members.

Securities class action settlements are structured to provide a fixed payment to the class regardless of the number of damaged shares. Attorney fees and costs are deducted from the settlement before the pro rata distribution to the class. In frivolous suits, the per share awards allocated to individual class members are insufficient to justify the expense of documenting and filing a claim. By separating attorney fees from the benefits offered individual class members, class counsel is not concerned whether the settlement actually benefits the class. If alternatively, attorney fees were a portion of actual claims filed, nuisance suits would not generate sufficient fees to justify the cost of filing the suit.

In addition to the PSLRA provisions on loss causation are provisions designed to empower class members. The PSLRA requires, for example, that settlement notices sent to shareholders present the settlement in per share terms. 15 U.S.C. 78u4 (7) (C). Attempts to comply with these provisions have resulted in unreliable and meaningless estimates that frustrate evaluation by both the courts and shareholders. The Hayes petition for certiorari in NICE argues that this Court's decision in Daubert v. Merrell Dow Pharmaceuticals, 509 U.S. 579 (1993) proscribes aggregate damage settlements leaving per share settlements as the only alternative. Per share settlement would eliminate the problems with estimating aggregate damages that are foreclosed by Daubert..

Proscribing aggregate damage settlements would reduce or eliminate frivolous securities litigation as lawyers would lose their risk free opportunity for multi-million dollar fee awards for bringing meritless litigation. (Cf. Pet. 12-15;

Reply 2-4) Granting a writ of certiorari on the forth-coming request for rehearing will allow this Court to support a balanced interpretation of loss causation to allow meritorous cases like Dura and Enron as the more speculative cases will simply not enter the courts.

SUMMARY OF ARGUMENT

The petitioner posits that since the passage of the PSLRA in 1995 that the circuit courts have adopted two conflicting standards for pleading loss causation under that statute. One first articulated In. Re.Cendant Corp., 191 F.R.D. 387 (D.N.J. 1998) holds that loss causation requires a stock decline following a disclosure which corrects previous misstatements or omissions.

> Basic liability in this case has been conceded, by the major corporate defendant. No one needs to be reminded that it was Cendant's public admission on April 15, 1998 that spawned this litigation. Id. 389

The second illustrated by the Ninth Circuit here and the Eight Circuit in Gebhardt v. Con Agra Foods Inc., 335 F. 3d 824 (8th Cir. 2003) holds that loss causation can be pled by alleging that the false and misleading statements caused artificial inflation of the stock price.

The conflict however is more apparent than real as the different standards reflect different underlying fact situations. Where corporations admit liability in a public disclosure and a stock price decline follows, the Third Circuit standard is appropriate for pleading loss causation. In most cases, however, corporations do not publicly admit their frauds rather public disclosures are calculated to prevent discovery of the fraud. In cases like Dura and Enron the only way to plead loss causation is to allege that the fraud artificially inflated the stock price.

Distinction should also be made between pleading and proving loss causation. Plaintiffs do not have to prove their case in the pleadings. Judge Easterbrook reiterated this principle in a recent PSLRA case. In reasoning applicable to pleading loss causation, Judge Easterbrook ruled that a PSLRA pleading case couldn't be dismissed before discovery. Asher v. Baxter Int'l Inc., 377 F. 3d 727 735 (7th Cir. 2004)

Petitioners' arguments against the Ninth Circuit standard are duplicitous and disingenuous. They cite a 33Act case, Bastian v. Petren Resources Corp., 892 F 2d 680 (7th Cir), that involved a newly issued oil and gas limited partnership that made no loss causation pleadings whatsoever to argue the "*Ninth Circuit's price-inflation theory of loss causation, ...is revolutionary and would radically alter... how loss causation has been applied in most circuits...*" Pet. Br. 26. Judge Posner was speculating in his opinion on potential facts the plaintiffs would need to plead loss causation in a case that is not remotely related to a fraud-on-the-market case like Dura.

Petitioners most serious argument is based on the presumption underlying the Ninth Circuit standard that investor losses are incurred at the time of the transaction by virtue of paying an inflated price for the stock. Petitioners correctly argue that investors are not damaged at this point as they could easily sell the stock at the artificially inflated price. However, the Ninth Circuit could just as easily presume that the investors losses are incurred later after an anomalous stock price decline reduced all or part of the artificial inflation.

ARGUMENT

A. The Alleged Conflict Among The Circuits On Loss Causation Fails On The Dura Facts

Petitioners' loss causation arguments assume that the $18/share drop in Dura's stock price on 2/25/98 had nothing to do with the probability that Dura's new drug application (NDA) for Spiros albuterol would not be approved. The petitioners attribute the decline solely to Dura's 2/24 announcement of slower drug sales of Ceclor CD and Nasarel/ Nasalide. The petitioners rely on the rejection eight months later on 11/3/98 as evidence that the alleged false statements on Spiros albuterol were not a factor in the 2/25 stock price decline. Br. 28.

Petitioners have a fundamental misunderstanding on how an efficient market works. While it is true that markets evaluate publicly released information, i.e. Dura's announcement of slower sales of Ceclor CD; they also ferret out and evaluate non-public information. Its likely that the bad news on Ceclor CD sales triggered a reassessment of Spiros albuterol based on existing non-public information even though Dura released no new information about Spiros albuterol. The strong form of the Efficient Market Hypothesis (EMH) holds that efficient markets incorporate non-public information in assessing public announcements. [6]

Its clear the prospects for the Spiros device was a co-factor with the increasing Ceclor CD sales in the substantial increase in Dura's stock price during the class period.

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[6] Wikipedia, Efficient Market Hypothesis, http://en.wikipedia.org/wikj/Efficient_market_hypothesis Boehme, Managerial Finance http://www.rdboehme.com/FIN_6335/Chap_13.pdf

Following a 1/20/98 conference call with Dura's CEO, Merrill Lynch informed its clients. "*By 2002, we believe that Spiros based products could contribute up to 50% of corporate revenue*." App. #130, p.107a.

However, as alleged in the complaint, the clinical trials supporting the Spiros albuterol NDA were not successful and Dura executives knew that it was likely that the FDA would not approve the device based on this research. The complaint cites a meeting among Dura executives prior to the filing of the NDA where defendant Prettyman made it very clear that he did not want to file the NDA, for which his department, Regulatory Affairs, was responsible. Prettyman, who worked for the FDA for over ten years, knew the NDA would not be approved. Shortly after this meeting Prettyman sold 15,000 shares of Dura stock on 11/5/97, his only sales during the class period. (App. #96 - #101, pgs. 89a-91a; #125, p. 104a) Such non-public information about a potential company making product would cause a major stock price decline if it was leaked or ferreted out by inquisitive market participants.

Following Dura's 2/24/98 announcement it was apparent to many investors that Dura had lied about the prior sales of Ceclor CD. As Alex. Brown analyst Ryan explained to his firm's Dura investors:

> Management credibility has been severely damaged by this announcement, particularly in light of recent investor conference presentations exuding confidence on the Company fundamentals....
>
> ...
>
> As recently as one month ago, we reviewed our model with the Company line by line and were guided to higher Ceclor CD estimates. App. #134, pgs. 109a-110a.

Investors, discovering that Dura management had lied about prior Ceclor CD sales, would begin frantic efforts to

discover other misrepresentations in order to assess what action should be taken on their Dura stock. Investors would quickly focus on Spiros albuterol, as the success of this product was as important or more important than the sales of Dura's existing drugs.

Contrary to petitioners' assumptions, the omission of any discussion of Spiros albuterol from the 2/24 announcement would raise questions on the likelihood of its FDA approval. In analyzing corporate announcements, investors have learned that companies try to offset bad news with positive news or at least reiterate previous expectations about other important products. The omission of comments on Spirios, the equivalent of damming by faint praise, would raise questions with Dura investors about the prospects for the highly touted Spiros albuterol application. Such questioning could lead to information on the problems encountered with the phase three trials; the division among Dura executives on the Spiros albuterol prospects or that a key executive sold stock days before the Spiros albuterol application was filed with the FDA. Alternatively, investors may have already been aware of these factors but had discounted their significance or reliability until the 2/24 announcement destroyed the credibility of Dura executives.

The Wall Street Journal (WSJ) had questions about Dura's 2/24 announcement and the unprecedented $18/share stock price decline on 2/25. In addition to highlighting the decline in the daily market column, the WSJ sought a fuller explanation. Significantly, officials at Dura couldn't be reached for further comment. The WSJ story quoted a CIBC Oppenheimer analyst who had projected an FDA approval of Spiros albuterol before the end of 1998 based on a 1/20/98 conference call with Dura officials. (App. #130, pgs. 107a-108a.)

Analyst, Steven V. Gerber, put a positive spin on the earnings shortfall speculating that half of the $.50/share

earnings miss was due to the announced sales force expansion. Gerber continued. "*Since they were already missing numbers, I think, they decided to go for broke and really build things up to get the most effective launch*" [for the Spiros product.][7] If this were true, Dura officials would have been happy to comment as this news would mitigate the seriousness of the sales drop of Ceclor CD and show confidence in an early approval of Spiros albuterol.

However, the market price of Dura stock continued to languish following the WSJ story, indicating that investors did not believe the Oppenheimer analyst's explanation. The lack of a market reaction to the WSJ story and the lack of a reaction[8] after the rejection of Spiros albuterol on 11/3/98 shows that the part of $18/share drop was due to the markets reassessment of the probability of Spiros albuterol success.

In summary, the facts alleged in the complaint are sufficient to connect part of Dura's $18/share drop to allegations that Dura had misrepresented the prospects of Spiros albuterol sufficient to satisfy the loss causation pleading requirements of the Third Circuit. If, however, this Court rejects the strong form of the EMH, the entire $18/share drop would be tied to the alleged misleading statements on Ceclor CD. This scenario squares with the more stringent loss causation pleading requirements. The Dura case is simply not one to resolve the perceived conflict among the circuits on the pleading requirements for loss causation.

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[7] Rundle, *Dura Shares Plummet on News That Results Will Miss Forecasts*, Wall St. J. Feb. 26, 1998 at B-10 E.

[8] Even though Dura's stock dropped $3.50/share on the disapproval announcement, the stock shortly recovered the entire loss. The rebound occurred in spite of an FDA action that Dura "sugar coated" the FDA's Spiros albuterol concerns in a press release.

B. There Is Or Should Be No Conflict Among The Circuits On The Pleading Requirements For Loss Causation

The general language in the 34 Act and PSLRA does not establish specific loss causation pleading requirements for private suits alleging 10b-5 violations. Rather the pleadings must demonstrate a causal connection between the 10b-5 violations and the damages incurred by investors. The Ninth Circuit has approved pleadings alleging that the defendant's misleading statements artificially inflated or depressed their stock price. In this scenario, investors' damages is the specific amount that the stock price is inflated or depressed determined by valuation analysis by experts at trial.

However, when the fraud is exposed in a public announcement, courts (including presumably the Ninth Circuit) have accepted pleadings citing the immediate (same day or next day) reaction of an efficient market. There is or should be no conflict in these standards as the particular facts dictate the appropriate standard.

The specific loss causation pleading should reflect the circumstances exposing the fraud. Many if not most securities frauds are not exposed by a single "corrective disclosure" but unwind over an extended period of days or even months making it impossible to correlate a specific stock price decline with the artificial inflation caused by the defendant's misleading statements. The Ninth Circuit's artificial inflation standard presumes an efficient market will discover and correct inflated price, most likely when its stock is in steep decline regardless of the public announcements. (Please see the discussion in D on 26.)

Petitioners' arguments that loss causation pleadings in a fraud-on-the market case always require a corrective disclosure followed by an immediate stock price decline are silly.

This is clearly shown by a cursory examination of the Enron fraud – the largest in history causing tens of billions of dollars damages to investors. The Enron suit, which is currently proceeding in district court in Houston, would be dismissed under the petitioners' loss causation requirements.

The APPENDIX (cited as A_) shows selected news reports from the Oil Daily (OD) chronicling the fall of Enron beginning with the unexpected resignation of its CEO on 8/14/01 to its impending bankruptcy on 11/29/01. Enron's stock price lost nearly all of its value falling from nearly $43/share to $.60/share in three months. However, there was never a "corrective disclosure" indicating that prior statements of earnings or Enron's prospects were false or misleading. Indeed on 8/24/01 the new CEO unequivocally denied that there were any undisclosed accounting issues. A2. The Oil Daily attributed Enron's $6/share price decline on 8/15 & 8/16/01 to a "slew" of business reversals. A1. However, on 9/19/01, Enron stock fell to $29/share after disclosing a $1.2 billion write-off due to the termination of a joint venture between Enron and a limited partnership headed by its CFO. It was only after Enron declared bankruptcy that the partnerships were found central to a fraudulent accounting scheme that allowed Enron to manipulate its earnings and artificially inflate its stock price.

Because there was no "corrective announcement" of the fraudulent partnership activity, it will be difficult to quantify how much of Enron's market decline was due to bad business decisions represented by the real partnership losses and how much was artificial price inflation due to Enron's reported earnings based on fictitious partnership profits.[9] There can be no doubt, however, that fictitious profits artificially inflated Enron's stock price and that investors were damaged when subsequent price declines eliminated the artificial inflation. That amount of inflation would be determined by

an investment banking analysis at trial. Plaintiffs are not required to prove their damages in their pleadings.

Under circumstances where fraud is discovered only after a period of declining stock market prices or is undiscovered, loss causation can only be pled by reference to artificial appreciation due to the alleged misleading statements or omissions. These circumstances are distinguished from those found by district court in Cendant where the company discovered an accounting fraud and quickly announced its discovery to an unsuspecting market.[10] With these rare circumstances, loss causation is or should be pled by reference to the immediate reaction of the market when the truth is revealed. Different pleading standards should reflect different circumstances and not conflicting interpretations among the circuit courts. Plaintiffs pleading loss causation should use the highest pleading standard that the facts allow, a "corrective disclosure" followed by an immediate market decline being the gold standard.

A key 34Act case purportedly showing that the Ninth Circuit's loss-causation pleading standard has been rejected by other circuits can be distinguished and/or shows a disagreement on the meaning of particular facts. In Robbins v. Koger Properties, Inc., 116 F. 3d 1441, 1448 (11th Cir. 1997) the court reversed a jury verdict awarding the plaintiffs an

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[9] A partial "corrective disclosure" came on November 4, 2004 nearly five years after Enron declared bankruptcy when a jury determined that ML and Enron engaged in a sham transaction that allowed the energy company to illegally book about $12 million in pretax profits in 1999. Emshwiller & Scannell, *Enron Trial Results in Five Guilty Verdicts – Convictions of Merrill Bankers Show Advisors Can Be Liable For Helping Mislead Investors*. Wall St. J., 11/4/04 at C-1 E.

[10] In. Re.Cendant Corp., 191 F.R.D. 387 389 (D.N.J. 1998) This decision underlies the Third Circuit's loss causation standards.

estimated $81 million. The circuit court had assumed that the defendants' misrepresentation "artificially inflated the price of [the company's] stock" but would not accept the fact that a stock price decline following the announcement of a 64% reduction in the dividend reduced the artificial price inflation.

First, Robbins is an overturned jury decision in a pre PLSRA fraud-on-the-market case. The appeals court held that no reasonable jury could have concluded that the defendant's misrepresentations were "*in some reasonably direct, or proximate, way responsible for [plaintiffs'] loss.*" Id. 1449 quoting Huddleston v. Herman & MacLean, 640 F 2d. 534 549 (5th Cir.), reversed in part, 459 U.S. 375 (1983). In overturning the jury decision, the appeals court rejected a retrospective application of the Ninth Circuit's artificial price appreciation loss causation standard. However, the appeals court's assessment of the lack of evidence in Robbins, is not relevant to debating pleading standards required to satisfy PSLRA requirements. Nothing in the PSLRA requires plaintiffs to prove their case in the pleadings.

More troubling is the fact the appeals court accepted the company's nonsensical explanation for the dividend cut and could not see the rather transparent relationship between the dividend cut the company's overstatement of its cash flow. The company's explanation is the equivalent to the Enron CEO denying there were undisclosed accounting issues that would explain Enron's declining stock price when it was later learned that Enron had been engaged in accounting fraud for sometime. n9-p19. In Robbins, the company's explanation for the dividend cut was a ruse to hide the fact that the company was fraudulently overstating its cash flow. Disagreement as to facts or the meaning of these facts in a pre-PSLRA case does not translate to a circuit court disagreement on pleading requirements in a PSLRA case.[11]

C. Petitioners' Arguments Against The Ninth Circuit's Price Inflation Standard For Pleading Loss Causation Are Duplicitous And Disingenuous

Petitioner and their amici wrongly presume that securities fraud pleadings that allege artificial inflation can not show that investors have been damaged absent a revelation of the truth followed by a corrective stock price decline. Petitioners' argue that pleading artificial inflation alone is inadequate to establish loss causation because investors' losses cannot be presumed to occur at the time of the transaction. Petitioners conclude that loss causation can only be pled in cases where the truth is revealed in a corrective disclosure.

Petitioner's otherwise sound arguments ignore the fact that securities fraud suits are not initiated when investors are blissfully enjoying paper profits of an artificially inflated stock price. Rather securities fraud suits are initiated after a significant drop in stock price after the alleged artificial price appreciation has been lost . The Dura suit, for example, was filed shortly after Dura stock dropped 47% in one day that was preceded by 20% decline in the prior three months. app.54a. Enron stock had declined by 50% in five months before the unexpected resignation of a new CEO caused its stock to drop another 16%. A1.

Securities suits are initiated after the artificial appreciation caused by allegedly false statements is lost. Pleadings of loss causation based on artificial price inflation can cite these

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[11] The Robbins appeal was decided shortly after the enactment PSLRA. The overturning of a jury verdict by an appeals court reinterpreting facts shows that in the post PSLRA period that circuit courts were leaning over backwards to dismiss the presumed meritless cases that PSLRA sought to eliminate. After Enron, in the shadow of an unprecedented wave of real accounting fraud, courts have and should judge with a more balanced view. Judge Easterbrook's opinion in Asher v. Baxter Int'l Inc., 377 F. 3d 727 (7th Cir. 2004) shows the new reality. Cf. n5, 7-8.

stock price declines as eliminating the artificial price inflation caused by the defendant's false and misleading statements. Investors do not have to prove loss causation in their pleadings. No one can say before evidence is introduced, whether a stated reason for a stock decline is really the truth (particularly when provided by defendants accused of fraud). Compare this with Judge Easterbrook's current reasoning on a related PSLRA issue.

> [A]ny particular caution, which always may be challenged as not sufficiently 'meaningful' or not pinning down the 'important factors that could cause actual results to differ materially." Asher v. Baxter Int'l Inc., 377 F. 3d 727 729 (7th Cir. 2004).
>
> ...
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> Baxter's chosen language may fall short. There is no reason to think... at the pleading stage, before plaintiffs have access to discovery – that the items mentioned in Baxter's cautionary language were those thought at the time to be the 'important' sources of variance. Id. 734. Cf. n.5 7-8.

In 34 Act cases, the magnitude of the stock decline preceding the filing of a securities class action is often an anomalous departure from historic trading patterns and belies the publicly disclosed information. In the absence of a "corrective disclosure" such price action can be cited in the pleadings to show a reduction in the artificial inflation and satisfy the loss causation standards. (Please see D on p. 26.)

Amicus Securities Industry Association (SIA) disingenuously argues that the artificial price inflation standard is inconsistent with statutory language of the 33 Act. According to the SIA, an actionable loss in 33 Act cases is "*the depreciation in value*" resulting from untrue or omitted statements from the prospectus. SIA Br. p.16. SIA asserts that this language forecloses a reduction in artificial price appreciation by an unspeci-

fied albeit anomalous stock price decline and that this interpretation would also apply to 34 Act cases.

However, 33 Act cases and companies are easily distinguished from 34 Act cases and companies and the SIA's use of the statutory language of the 33 Act to interpret the 34 Act is really disingenuous. 33 Act companies are recently private companies often in new industries with innovative products which are raising public capital for the first time. Most are unprofitable with little or no revenue. The valuation metrics investors use to value 33 Act stocks is as new and varied as their products. Information provided investors about the business of these companies is tightly regulated and vetted by the underwriter and the SEC. 33 Act stock prices are volatile after their introduction to the public market. Eventually most of these companies fail or merge with stock prices declining substantially from the offering price.

Using language from the 33 Act to interpret the 34 Act may seem valid. However, the high volatility and expected stock declines of the typical 33 Act company that may justify strict statutory loss causation pleading requirements for these companies are not found in 34 Act companies with longer trading histories and lower price volatility. For mature profitable companies with established trading histories a sudden 47% price drop – on negative but hardly catastrophic news as seen in Dura – is both strong evidence that the prior trading range was artificially inflated and for pleading loss causation.

Amicus ML continues, urging "*rigorous loss causation standards*" to weed out hundreds of post-bubble meritless cases. ML Br. 18-24. ML cites the record 503 private federal securities law class action suits filed in 2001. The Securities Class Action Clearinghouse, however, classifies 176 of these cases as "classic" securities fraud (34 Act) with the remaining 65% being IPO and Analyst cases (33 Act).[12] Loss causation

arguments based on 33 Act cases are not relevant to 34 Act cases such as Dura. Specifically, it is not appropriate to cite the 33 Act, Bastian v. Petren Resources Corp., 892 F. 2d 680 (7th Cir.), cert. denied, 496 U.S. 906, to argue that without restrictive loss causation standards "*Section 10(b) would be an uncompensated insurance mechanism covering losses attributable to events other than defendant's fraud. …Speculators in a risky market could effectively transfer the risk of bad investments to issuers…*" ML Br. 9.

The Petitioner also cites Bastian – "*No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation.*" Id. 686 – to support its argument that the "*Ninth Circuit's price-inflation theory of loss causation, … is revolutionary and would radically alter … how loss causation has been applied in most circuits…*" Pet. Br. 26. Petitioner's reliance on the cited language is even more ridiculous considering it is merely dicta speculating on the reason for the investment loss. More telling for the argument here, Judge Posner acknowledged that loss causation could be established in the face of the unanticipated change in business conditions.

> Perhaps if the plaintiffs had conducted [research] they would have discovered, contrary to our speculation (and it is just that), that oil land gas ventures managed by competent and honest businessmen *had* survived the drop in oil prices. If so, this would support an inference that if the defendants had been as competent and honest as they represented themselves to be, they would not have lost the plaintiffs' $600,000. Id. 684

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[12] Stanford Law School Securities Class Action Clearing House, http://www.securities.stanford.edu/2001

This language suggests that the Ninth Circuit's price inflation theory is not revolutionary but is in fact consistent with how loss causation is applied in other circuits.

Amicus Chamber of Commerce cites Bastian as a Seventh Circuit decision that conflicts with the Ninth Circuit. Chamber 3. The Chamber also cites Bastian at 685 as its sole support to wildly speculate that the "*Ninth Circuit's rule … will also serve to chill investment advice and reporting and the free flow of information in our capital markets.*" Chamber 16. Bastian is a 33 Act case, an oil & gas limited partnership sold at the last peak in oil prices that was apparently organized by "fly by night" promoters who misrepresented their expertise in the offering memoranda. The securities never traded in a market and contrary to assertions by the petitioners and their amici would not even meet the Ninth Circuit's artificial price inflation loss causation standard that requires investors bid up the price of a security in response to false and misleading disclosures. Arguments to the contrary are disingenuous and duplicitous. [13]

ML, Chamber, and SIA concerns about frivolous class action suits and "blackmail settlements" would be more appropriately addressed upon the granting of a writ of certiorari in Nice Systems, case no. 03-1676. Proscribing aggregate damage settlements as argued in the NICE petition, would eliminate the incentive for lawyers to file low merit suits.

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[13] Petitioners and their amici cite at least one other 33 Act case in arguing against the application of the Ninth Circuit's price appreciation standard in Dura, a 34 Act company. Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc. 343 F. 3d 189 (2nd Cir. 2003) is a private placement. The Chamber cites Emergent as a Second Circuit conflict with the Ninth. Chamber Br 3 n.4. (Cf. Pet. Br. 29; Technology Network Br. 3,4 & ML Br. 9) This amicus' review did not examine all the cases cited nor other amici briefs that are not cited.

Reducing the number of suits filed would reduce the burden on the courts in distinguishing low merit suits.

D. Although The Ninth Circuit's Presumption Justifying Its Loss Causation Standard Is Incorrect; An Alternative Presumption Justifies Its Standard And Reconciles It With *Basic* And The Other Circuits

The Ninth Circuit's artificial price inflation loss causation model presumes that an investor's loss "*occurs at the time of the transaction*," when he is harmed by paying too much, and a causal connection exists because it is the misrepresentation that inflated the price. (SEC Br. 21 quoting the opinion.) The SEC then argues that this view is mistaken because "*a purchase-time value disparity, standing alone, cannot satisfy the loss causation pleading requirement.*" Id. 21 citing Emergent, 343 F.3d at 198. Disregarding that Emergent is a private placement that should have no relevance to fraud-on-the market disclosures, there is an alternative presumption that justifies the Ninth Circuit standard. The new presumption would also bring the standard into conformance with Basic Inc. v. Levinson, 485 U.S. 224 (1988) and standards other circuits have applied in 34Act cases.

The Ninth Circuit could just as easily have justified its loss causation standard by presuming that the investor's loss from purchasing an artificially inflated stock does not occur at the time of purchase but later following an anomalously large decline in market value of a stock. That decline could be triggered by a purportedly exogenous disclosure or no disclosure at all. Real fraud-on-the-market cases like Enron and WorldCom involve subtle manipulation of earnings to show quarter to quarter increases that investors favor with a premium valuation as expressed by the price-earnings ratio (P/E ratio). Then, for example, if a company perpetrating a fraud discloses a business reversal unrelated to the fraud, the drop in stock price will at

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st in part be due to a reduction in the premium P/E that was
ised by the alleged fraud. The reduction in the P/E ratio then
uld reduce the artificial inflation. Thus in pleadings alleging
ificial inflation, loss causation is established by any anoma-
s decline as the market can no longer justify the premium P/E
io created by the fraud.

An anomalous decline, for example, could be one that is
usually large when compared to a particular stock's trading
tory or that of its industry index. Dura's 47% one day
cline was by far the largest in a six year trading history.
p. 54a. A decline also could be anomalous if, for example,
was out of proportion to the concurrent disclosure. Market
dence might show, for example, that Dura's 47% decline
s anomalous in light of its disclosure that the rate of
rease of its Ceclor CD sales for 1998 would be one half
analysts expectations and the lower growth would be
ieved only after the company added more sales people. [14]
erck's stock, for example, only declined by 27% on the
nouncement it would withdraw VIOX with $2.5 billion in
nual sales because of an increased risk of heart attacks. [15]

The alternative price inflation model is nicely supported
he legislative history of the PSLRA as noted in the SEC's
f at 26. The House and Senate Conference Committees'
nference Report explaining loss causation provides an

[14] 1998 Dura's announcement of slower Ceclor CD sales expectations in 1998 is consistent with the complaint's allegations that it overstated 1997 sales by "stuffing" the distribution channel. By not making a corrective disclosure, Dura hopes to avoid liability for fraud. Because companies committing securities fraud rarely disclose their frauds; flexible loss causation standards are required to prevent dismissal of meritorious cases.

[15] Simons & Stipp, *Merck's $27 Billion Heart Attack Lawyers are circling, Wall Street is howling. Can the proud drug giant survive the Vioxx mess?* Fortune Nov. 1, 2004

example that states: "*the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.*" SEC Br. citing H.R. Conf. Rep. No. 369 at 41 and S. Rep. No. 98 at 15. The SEC notes that these reports support the Ninth Circuit's standard but then disregards the reports because of the Ninth Circuit's erroneous presumption that shareholders are damaged at the time of purchase. The alternative presumption that shareholders are damaged by an anomalous price decline subsequent to purchase ties in nicely with the Conference Report.

CONCLUSION

The judgment of the court of appeals should be affirmed.

November, 2004

Respectfully Submitted,

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APPENDIX

CHRONOLOGY OF ENRON'S ANOMALOUS STOCK PRICE DECLINE

8/17/01 - Enron Stock Slide Continues;

Enron stock closed more than 8% lower, to close at **$36.85/share**. The value has declined almost $6/share in the past two days, following the announcement late Tuesday that Jeff Skilling, the chief executive since February, had resigned.

Last summer, Enron shares hit their highest ever price at $90.75/share and still were trading at around $80 when Skilling assumed the top position…

A slew of factors contributed to the market's loss of confidence in Enron and the accompanying slide in stock value. Its once-vaunted broadband business is losing large sums of money and has never recovered from the loss of a movie-on-demand deal with Blockbuster Video in March. The Dabhol Power project, at one time the prize example of foreign investment in India, has turned into a debacle and now is for sale.

Compounding the situation was last week's explosion at the Teesside power plant in the UK and the loss of three workers (OD Aug.9, p2). The company mysteriously withdrew from two high profile Middle East gas ventures, including a stake in one of three Saudi Arabian gas openings. California's attorney general has issued virtual "wanted posters" for the company and its execs for allegedly causing the state's electricity crisis. Finally, the New Power retail electricity joint venture with America Online and IBM is not progressing as fast as expected. The Oil Daily. (OD)

8/24/01 – Q & A Interview with Lay

Q. There has been some concern among investors that… perhaps accounting or other issues that have yet come to light. Is there anything more?

A. There are absolutely no problems that had anything to do with Jeff's departure. There are no accounting issues, no trading issues, no reserve issues, no previously unknown problem issues. The company is probably in the strongest and best shape that it has ever been in. Business Week Online.

9/7/01 – Enron Stock Continues to Fall;

The stock closed at **$30.49** down almost $12/share since former Chief Executive Jeff Skilling resigned on Aug. 14.

Analysts contacted by Oil Daily were at a loss to explain the continued decline in the absence of specific news. OD.

9/19/01 – Enron Stock Thrashed Over Disclosure…;

Beating up on Enron's common stock has become an almost regular event on Wall Street, but Thursday's thrashing was particularly brutal as the price slid $3.20, or almost 10%, to **$29/share** in heavy trading.

The reason was investors' unhappiness over Enron's failure to disclose adequately a $1.2 billion charge to equity included in the third-quarter financial results released earlier this week (OD Oct.17,p1).

Thursday's decline came on top of $1.64 drop on Wednesday, when more details of a terminated joint venture arrangement between Enron and a limited partnership headed by its Chief Financial Officer Andrew Fastow. OD.

10/24/01 – Enron Chief Fails to Stem Stock Slide;

Enron closed at **$19.79**. Enron executives tried to affirm that all was well in the core businesses… and to steer the inquiries away from financial obligations and corporate credit worthiness. Lay denied that Enron is concealing any material information. OD.

10/31/01 – Takeover Talk Can't Halt Enron Stock Plunge;

Enron shares fell $2.65 to close at **$11.16/share** in spite of reports that either BP, General Electric, or Royal Dutch/ Shell was about to make a bid for the battered natural gas and power trading giant.

Enron stock has fallen more than 60% since third-quarter financial results showing a $1 billion asset write down, a $632 million net loss, and a $1.2 billion charge to equity were disclosed two weeks ago… Investors and analysts were livid that Enron had not honored its pledge to be more open and transparent about its financials. OD.

11/12/01 – Dynegy Seals Deal to Acquire Enron

The agreement calls for each share of Enron stock to be exchanged for just under 0.27 shares of Dynegy, or about $10.41 for each Enron share. Enron stock, which traded as high as $90.75 in August 2001, closed Friday at **$8.63**, up a mere 22[cent] on the day. Dynegy ended at $38.76, up $2.26. OD.

11/21/01 – Enron Stock Plunges on Credit Concerns;

Enron shares stood at **$6.99/share** – or about 39% below Dynegy's bid price of $11.60/share – spurring fears that the deal may fall through.

"Although Enron's recent disclosures help shed light on the true financial condition of the firm, the disclosures continue to be piecemeal and it appears that the full extent of Enron's problems is not currently known, ...[The company] remains in a precarious financial position and its status as a going concern is much in doubt." OD. quoting Commerzbank securities analyst Andre Meade.

11/26/01 – Enron Share Price Dives;

[I]nvestors remained concerned as to whether the company can stay afloat long enough to complete its merger with rival Dynegy.

Those concerns deepened as Enron's stock price slumped by 28% on Wednesday – to barely **$5** – on top of a 23% drop the previous day. Analysts said the firm could be forced into bankruptcy if the deal with Dynegy were to fall through as a result. OD.

11/29/01 – Enron Bankruptcy Likely as Dynegy Walks;

Dynegy, Enron's last good hope for a rescue from its financial failings, walked away from the proposed acquisition Wednesday, leaving the once-mighty natural gas and power trading company with no option but the bankruptcy court.

...

The deal killer in this corporate drama came mid-morning Wednesday when credit agency Standard and Poor's cut Enron's rating to junk status. Moody's Investors Service and Fitch quickly followed. This accelerated massive debt repayment obligations.

...

Enron's already depressed common stock lost almost all its remaining value. It fell to **60[cent]** at one point from Tuesday's close of $4.11. OD.